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In the Supreme Court of the United States

OCTOBER TERM, 1987

MARYLAND NATIONAL BANK, APPELLANT

v.

STATE DEPARTMENT OF ASSESSMENTS AND TAXATION

ON APPEAL FROM THE COURT OF APPEALS OF MARYLAND

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

CHARLES FRIED
Solicitor General
JOHN R. BOLTON
Assistant Attorney General
LOUIS R. COHEN
Deputy Solicitor General
CHARLES A. ROTHFELD
Assistant to the Solicitor General
ANTHONY J. STEINMEYER
MICHAEL KIMMEL
Attorneys
Department of Justice
Washington, D.C. 20530
(202) 633-2217

QUESTION PRESENTED

Whether 12 U.S.C. 1433 bars a state from taking the earnings from Federal Home Loan Bank bonds into account in computing a corporate franchise tax.

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BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is submitted in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

Appellant is a financial institution that is subject to the Maryland franchise tax, a tax on the privilege of doing business as a corporation in the state. The tax on such an institution is set at seven per cent of the institution's "net earnings," an amount that is defined to mean "the net income of such financial institution," including "interest upon obligations of the United States * * * and of [its] instrumentalities." Md. Code Ann. art. 81, § 128A (1980). In calculating its net earnings for the tax years 1979 through 1982, appellant, under protest, included some $2.8 million in interest earned on consolidated Federal Home Loan Bank (FHLB) bonds, a step that increased its franchise tax liability by $197,310. Pointing to 12 U.S.C.

1433—which provides that "consolidated Federal Home Loan Bank bonds and debentures[] shall be exempt both as to principal and interest from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States, by any Territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority"—appellant then sought a refund of this amount from appellee, arguing that Section 1433 prohibits states from taking FHLB bond income into account when calculating franchise taxes. Appellee denied the refund request. J.S. App. 38a-39a.

Appellant responded by filing a refund suit in the Maryland Tax Court. That court ordered payment of the refund (J.S. App. 26a-33a), accepting appellant's argument "that the plain meaning of [Section 1433] prohibits States from imposing franchise taxes measured in part by interest income generated by Federal Home Loan Bank Bonds" (*id.* at 29a). The Circuit Court for Baltimore City affirmed (*id.* at 14a-25a), agreeing that the "plain wording" of Section 1433 "prohibits Maryland from taxing the interest earned on FHLBBs in net earnings for franchise tax purposes. Congress stated that it exempted interest on FHLBBs from *all* taxation except *surtaxes, estate, inheritance and gift taxes.* It did *not* except franchise taxes." J.S. App. 15a (emphasis in original). The court found unpersuasive appellees' reliance on 31 U.S.C. 3124(a), which permits states to take interest on "obligations of the United States Government" into account when calculating "a nondiscriminatory franchise tax * * * imposed on a corporation"[1]; the court held that FHLB bonds

[1] Section 3124(a) provides that "[s]tocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of

are not obligations of the United States within the meaning of Section 3124(a) and that, "[e]ven if FHLBBs are obligations of the United States, Sec. 1433 is nevertheless controlling because the specific statute governing FHLBBs controls over the general provisions in Sec. 3124(a)" (J.S. App. 17a).

The Court of Appeals of Maryland reversed, holding that income from the FHLB bonds may be taken into account in computing appellant's tax liability (J.S. App. 1a-13a). Because the court of appeals believed that the bonds are obligations of the United States (*id.* at 9a-12a), it concluded that both Sections 1433 and 3124(a) appear to apply in this case; in the court's view, the plain terms of the former statute prohibit the state from taking FHLB bond income into account in calculating the franchise tax, while the language of the latter statute permits consideration of the bond income. To reconcile this conflict, the court looked to a line of this Court's decisions, both before and after the enactment of Section 1433 in 1932, that " 'consistently upheld franchise taxes measured by a yardstick which includes tax-exempt income or property' " (J.S. App. 5a (quoting *Werner Machine Co.* v. *Director of Div. of Taxation,* 350 U.S. 492, 494 (1956)). The court of appeals accordingly held (J.S. App. 7a-8a) that

> the two statutes can be read compatably [*sic*] by reading 12 U.S.C. § 1433 in light of the direct tax-indirect measurement distinction which shone more brightly in 1932, when § 1433 was enacted, than it does today. The Maryland franchise tax does not of-

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taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except—(1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and (2) an estate or inheritance tax."

> fend § 1433[] * * * because Maryland has not taxed the bonds or the interest on them. Maryland has taxed the privilege of doing business as a financial institution in corporate form in this state and has measured the tax by net income which constitutionally may, under the principle established by the intergovernmental immunity cases cited above, include interest on federal obligations.

ARGUMENT

For reasons we explain below (see note 5, *infra*), we believe that Section 3124(a) has no direct application in this case. In our view, the dispositive question here is whether Section 1433 prohibits the consideration of FHLB bond income in the computation of a state corporate franchise tax. While the meaning of that statute is not, unfortunately, entirely clear, on balance we believe that the court below gave Section 1433 the better reading when it held that revenue from the bonds may be taken into account in calculating appellant's tax liability. Plenary review accordingly is not warranted.

1. Obligations issued by the United States and its instrumentalities are constitutionally immune from state taxation, and since 1862 Congress has reinforced this constitutional immunity with a succession of laws providing, in the language of the Revised Statutes, that all federal bonds and other obligations "shall be exempt from taxation by or under State or municipal or local authority." Rev. Stat. § 3701 (1878 ed.), codified at 31 U.S.C. (Supp. I 1959) 742, recodified at 31 U.S.C. 3124(a).[2] See *Smith* v.

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[2] The Act of Feb. 25, 1862, ch. 33, § 2, 12 Stat. 346, exempted all "stocks, bonds, and other securities of the United States" from state taxation. This and several related statutes were the predecessors to

Davis, 323 U.S. 111, 116-118 & n.7 (1944). The Court has given force to these constitutional and statutory requirements by regularly invalidating "state taxes imposed *on* federal obligations." *American Bank & Trust Co.* v. *Dallas County*, 463 U.S. 855, 858 (1983) (emphasis in original). The Court also, however, has "consistently held * * * that § 3701 did not prohibit nondiscriminatory taxes imposed on discrete property interests such as * * * business franchises, even though the value of that discrete interest was measured by the underlying assets, including United States obligations" (*ibid.*).

As the Court has recognized, this was a "formal but economically meaningless distinction" (*American Bank & Trust*, 463 U.S. at 858), since there is no real difference between a tax on the income from federal obligations on the one hand and, on the other, a franchise tax that is calculated as a percentage of all income, including income from federal obligations (see *id.* at 862). But the Court nevertheless upheld franchise and other excise taxes that were "measured by the value of federal obligations * * * on the theory that the tax was levied on the franchise or the transfer of property, rather than on the ownership interest in the federal securities themselves" (*id.* at 863-864). See, *e.g.*, *United States* v. *Wells Fargo Bank*, No. 86-1521 (Mar. 23, 1988), slip op. 4; *Werner Machine Co.* v. *Director of Div. of Taxation*, 350 U.S. 492, 494 (1956) (per curiam).[3]

Rev. Stat. § 3701 (1878 ed.), which was placed on the books in 1873. See *Smith* v. *Davis*, 323 U.S. 111, 117-118 & n.7 (1944).

[3] In 1959 Congress amended Rev. Stat. § 3701 (1878 ed.) to provide that the tax exemption for federal obligations extends "to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly, or indirectly, in the computation of the tax." Act of Sept. 22, 1959, Pub. L. No. 86-346, § 105, 73 Stat 622. This amendment "rejected and set aside [the] Court's

In 1932, when Congress enacted Section 1433, it surely was aware of the Court's approach to tax immunity. By that time, the Court already had repeatedly permitted the imposition of state franchise and other excise taxes on the value of federal obligations, notwithstanding Rev. Stat. § 3701 (1878 ed.) and its predecessors. See, *e.g.*, *Des Moines Nat'l Bank* v. *Fairweather,* 263 U.S. 103, 112 (1923); *Home Savings Bank* v. *Des Moines*, 205 U.S. 503, 513, 516-519 (1907); *Home Ins. Co.* v. *New York*, 134 U.S. 594, 599-606 (1890); *Society for Savings* v. *Coite,* 73 U.S. (6 Wall.) 594, 604 (1868); *Provident Institution* v. *Massachusetts,* 73 U.S. (6 Wall.) 611, 622-623 (1868). Indeed, in the year immediately preceding enactment of Section 1433, the Court twice forcefully "reaffirmed the distinction, repeatedly made in earlier decisions, between a tax, invalid because laid directly on governmental instrumentalities or income derived from them, and an excise which is valid because imposed on corporate franchises, even though the corporate property or income which is the measure of the tax embraces tax exempt securities or their income." *Educational Films Co. of*

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rather formalistic pre-1959 approach to § 3701." *American Bank & Trust*, 463 U.S. at 862. Even the amended version of Section 3701, however, created an exception to the exemption for "nondiscriminatory franchise and other nonproperty taxes in lieu thereof imposed on corporations and * * * estate taxes and inheritance taxes." Title 31 of the United States Code was enacted into positive law in 1982, at which time Section 3701 was recodified at 31 U.S.C. 3124(a) without substantive change. See *American Bank & Trust Co.* v. *Dallas County*, 463 U.S. at 858-859 & n.1. States accordingly may still consider the interest from and principal of federal obligations in calculating franchise taxes. See *Department of Revenue* v. *First Union Nat'l Bank*, 513 So.2d 114 (Fla. 1987), appeal dismissed No. 87-1074 (Mar. 21, 1988); *Garfield Trust Co.* v. *Director, Div. of Taxation,* 102 N.J. 420, 508 A.2d 1104, appeal dismissed, 479 U.S. 925 (1986).

America v. *Ward*, 282 U.S. 379, 389-390 (1931). See *Pacific Co.* v. *Johnson*, 285 U.S. 480, 490 (1932).

Against this background, Congress would neither have intended nor expected to prevent states from taking the value of FHLB bonds into account in computing a corporate franchise tax when it provided, in Section 1433, that FHLB bonds "shall be exempt both as to principal and interest from all taxation." Indeed, this Court recently reached that very conclusion in interpreting a virtually identical tax exemption provision enacted by a roughly contemporaneous Congress. In *United States* v. *Wells Fargo Bank, supra,* the Court, addressing a statute that made certain federal notes "exempt from all taxation now or hereafter imposed by the United States" (the Housing Act of 1937, ch. 896, § 5(e), 50 Stat. 890, 42 U.S.C. 1437i(b)), explained that "an exemption of property from all taxation had an understood meaning: the property was exempt from *direct* taxation, but certain privileges of ownership * * * could be taxed." Slip op. 4 (emphasis in original). The Court accordingly held that the statute at issue in *Wells Fargo* should not be read to foreclose the imposition of federal estate taxes on the transfer of the tax exempt notes. Similarly here, the language of Section 1433 providing that FHLB bonds "shall be exempt * * * from all taxation," when "[p]laced in context, * * * does not stand for [appellant's] proposition that [FHLB bonds] were intended to be exempt from [franchise] taxes; it stands for exactly the opposite." *Wells Fargo*, slip op. 5.

This conclusion also accords with Congress's consistent policy of allowing states to consider the value of federal obligations when setting corporate franchise taxes. Although undoubtedly aware of this Court's interpretation of Rev. Stat. § 3701 and its predecessors, Congress has

at no time generally attempted to foreclose state consideration of federal obligations in setting franchise taxes. To the contrary, in 1926, six years before the enactment of Section 1433, Congress passed legislation expressly permitting states to impose franchise taxes on national banks that would be "measured by" the "net income received [by the bank] from all sources." Act of Mar. 25, 1926, ch. 88, § 1, 44 Stat. 223, codified at 12 U.S.C. (1964 ed.) 548. This provision was "intended to authorize a franchise tax measured by net income including interest on tax-immune federal securities." *Tradesmen's Nat'l Bank* v. *Oklahoma Tax Comm'n,* 309 U.S. 560, 563-564 (1940).[4] Similarly, when Congress amended Rev. Stat. § 3701 (1878 ed.) in

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[4] Congress explained at the time that, in states imposing a corporate franchise tax, "the practice is to include income from all sources, including income from tax-exempt securities, in arriving at the measure of the tax based on net income." Congress therefore found it "desirable, in order to establish complete taxing parity [between national and state banks], to remove any question as to the inclusion of income from tax-exempt securities as part of the measure of the tax based on the net income of national banking associations." H.R. Rep. 526, 69th Cong., 1st Sess. 2 (1926). Congress also recognized that this Court's decisions permitted the inclusion of income from federal obligations in the calculation of state franchise taxes. See *ibid.*; 67 Cong. Rec. 5761 (1926) (remarks of Sen. McLean); *id.* at 6085 (colloquy between Reps. Wingo and Cooper). This Court has subsequently explained that the 1926 legislation was principally designed to prevent states from discriminating against national banks, and not to settle the franchise tax status of federal obligations; the Court has therefore indicated that the 1926 enactment should not be read to permit the taxation of federal obligations that are held by national banks when those obligations would be tax exempt in the hands of other taxpayers. *American Bank & Trust*, 463 U.S. at 869-873. The 1926 legislation nevertheless does demonstrate Congress's awareness, and general approval, of the consideration of federal obligations in the calculation of state franchise taxes.

1959 to prohibit states from "consider[ing]" the value of federal obligations "in the computation of [a] tax" (see note 3, *supra*), it created an express exception to this new rule for nondiscriminatory corporate franchise taxes. That exception was continued in effect when Rev. Stat. § 3701 was codified at 31 U.S.C. 3124(a). There is nothing in the nature of FHLB bonds suggesting that Congress intended to entitle them to more favorable tax treatment than is granted to federal obligations generally.[5]

2. Having said this, we should add that there is one significant piece of evidence in this case that supports appellant. As appellant notes (J.S. 12-16 (emphasis added)), Congress placed a parenthetical exception in Section 1433: the statute provides that FHLB bonds "shall be exempt

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[5] Because appellant relied only on Section 1433 in claiming tax immunity, there was no need for the court of appeals to find an affirmative authorization for the franchise tax in 31 U.S.C. 3124(a); given this Court's decisions establishing that the Constitution does not prevent the states from considering obligations issued by federal instrumentalities (such as Federal Home Loan Banks) when setting franchise taxes, Maryland is free to impose the tax at issue in this case so long as a franchise tax immunity is not conferred by Section 1433. We note, however, that we disagree with the court of appeals' conclusion that Section 3124(a) provides an affirmative authorization for the tax. That provision refers only to "obligations of the United States Government." Such obligations are ones for which, among other things, "the credit and faith of the United States was pledged." *Smith*, 323 U.S. at 118. See also *Rockford Life Ins. Co.* v. *Illinois Dep't of Revenue*, No. 86-251 (June 8, 1987), slip op. 5-6. Congress has expressly provided that FHLB bonds "are not obligations of the United States and are not guaranteed by the United States." 12 U.S.C. 1435. The immunities (and disclaimers) of Section 3124(a) therefore are inapplicable to those bonds. Even this conclusion, however, cuts against appellant, since it would be peculiar for Congress to have given more favorable tax treatment to obligations that are not backed by the full faith and credit of the United States (such as FHLB bonds) than it gave to ordinary government bonds in Section 3124(a).

both as to principal and interest from all taxation *(except surtaxes, estate, inheritance, and gift taxes).*" Congress's decision to list several taxes that are exceptions to the general exemption, while omitting franchise taxes from the list, may give rise to an inference that Congress wished to foreclose the imposition of franchise taxes. We nevertheless believe that Section 1433 should not be read to prevent the consideration of FHLB bonds in setting franchise taxes.

Understanding Congress's likely intention in writing this parenthetical requires a consideration of the contemporary tax system. At the time Section 1433 was enacted, there were two parts to what is now the federal income tax: a "normal" tax set at a low flat rate, and a graduated "surtax." See *Wells Fargo,* slip op. 5. Congress plainly wanted to subject income from FHLB bonds to the surtax. Yet, as the Court explained (slip op. 5-6) in discussing a virtually identical tax exemption provision in *Wells Fargo* (the Housing Act of 1937, ch. 896, § 20, 50 Stat. 898, 42 U.S.C. (1946 ed.) 1420):

> as the normal tax and the surtax were both direct, simply making the federal obligations "exempt from all taxation" would exempt too much. Thus, Congress "excepted" surtaxes from the exemption. But that exception, if left by itself, would have created its own anomaly: the strict application of the rule "*expressio unius est exclusio alterius*"—*i.e.*, the expression of one is the exclusion of others—would have resulted in exempting these obligations from all taxes, direct or indirect, except the surtax. To avoid that particular pitfall, Congress also excepted estate, inheritance, and gift taxes.

Estate, inheritance, and gift taxes are, like the franchise tax, indirect. See, *e.g., Wells Fargo,* slip op. 4; *American Bank & Trust,* 463 U.S. at 858; *Plummer* v. *Coler,* 178

U.S. 115 (1900). That Congress felt it necessary to except these taxes from the reach of Section 1433 accordingly suggests that it may have believed franchise taxes to be prohibited by the provision, in the absence of an express exception. Cf. *American Bank & Trust,* 463 U.S. at 864.

While this argument has force, on balance we believe that it should not overcome the other evidence, set out above, indicating that Congress did not want to foreclose the consideration of FHLB bonds in the calculation of state franchise taxes. At the outset, as we explain above, the operative language of Section 1433—the language that actually creates the tax exemption by providing that FHLB bonds are exempt from "all taxation"—would not by itself have been understood to foreclose state franchise taxes. And the limited legislative history confirms, as common sense indicates, that the Section 1433 parenthetical was added because the basic exemption was understood to be too broad. As originally considered in committee, Section 1433 contained the unadorned tax exemption; when this was criticized as too generous to taxpayers, the committee "very cheerfully agreed to make [FHLB bonds] subject to surtaxes, gift taxes, and inheritance taxes." 75 Cong. Rec. 12590-12591 (1932) (remarks of Rep. Stevenson).[6] Appellant's reading would mean that Congress's attempt to *narrow* a tax exemption that, as originally written, permitted franchise taxes, had the opposite effect of making franchise taxes impermissible. Allowing a canon of construction to compel such a reading of the statute would be perverse.

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[6] Even this modified version drew criticism as being too generous (see 75 Cong. Rec. 12591 (1932) (remarks of Rep. Stevenson)), but an attempt to delete the entire tax exemption provision was defeated (*id.* at 13108).

That is particularly so in this case, since Congress did not choose the language of the Section 1433 parenthetical with care: Congress evidently borrowed the parenthetical verbatim from a recently enacted tax exemption provision of the Reconstruction Finance Corporation Act of 1932, ch. 8, § 10, 47 Stat. 9. See 75 Cong. Rec. 13108 (1932) (remarks of Rep. Luce). In these circumstances, the Section 1433 parenthetical does not provide the "unambiguous[] pro[of]" necessary to give appellant an exemption from the Maryland franchise tax. *Wells Fargo,* slip op. 3. See generally *Rockford Life Ins. Co.* v. *Illinois Dep't of Revenue,* No. 86-251 (June 8, 1987), slip op. 9.

CONCLUSION

The motion to dismiss should be granted.

Respectfully submitted.

CHARLES FRIED
Solicitor General
JOHN R. BOLTON
Assistant Attorney General
LOUIS R. COHEN
Deputy Solicitor General
CHARLES A. ROTHFELD
Assistant to the Solicitor General
ANTHONY J. STEINMEYER
MICHAEL KIMMEL
Attorneys

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